

UNITED STATES BANKRUPTCY COURT  
NORTHERN DISTRICT OF CALIFORNIA

SONICBLUE INCORPORATED,  
Debtor.

Case No.-03-51775-MM  
Chapter 11

SONICBLUE INCORPORATED, et al.,  
Plaintiffs,  
vs.

Adversary No. 05-5106

VIRTUAL TRANSPORTATION  
MANAGEMENT, INC.,  
Defendant.

**MEMORANDUM DECISION ON  
PLAINTIFFS' MOTION FOR PARTIAL  
SUMMARY JUDGMENT AND  
DEFENDANT'S MOTION FOR  
SUMMARY JUDGMENT**

**INTRODUCTION**

In this adversary proceeding, the debtors seek to avoid and recover \$578,020.31 that one of the debtors, Diamond Multimedia Systems, Inc., transferred to defendant Virtual Transportation Management, Inc. during the ninety day period preceding the petition date. The debtors have moved for partial summary judgment seeking a determination that VTM is an "initial transferee" under § 550 of the Bankruptcy Code from whom debtors may recover any avoided transfers. In response, VTM has

1 filed a cross-motion for summary judgment asserting that it received the funds as Diamond's agent and  
2 did not have sufficient dominion or control over the funds to be considered a transferee. Alternatively,  
3 VTM contends that if it is a transferee, it received the funds in the ordinary course of business.

4  
5 **BACKGROUND**

6 Prior to bankruptcy, Diamond sold and distributed consumer electronics that were manufactured  
7 by third parties. As part of this business, Diamond engaged various freight carriers to ship the products  
8 to Diamond and from Diamond to assorted retailers throughout the country.

9 VTM is a company that provides freight-bill audit, payment and reporting services to customers  
10 like Diamond. VTM's customers directly hire freight carriers to ship goods, but after the goods are  
11 shipped, the freight carriers send their invoices to VTM, who processes the invoices and verifies that  
12 payment is appropriate. VTM compiles and forwards periodic reports to its customers to inform the  
13 customer about invoices that are ready for payment. The customer then provides the necessary funding  
14 and VTM pays the freight carriers.

15 This is exactly the type of arrangement that Diamond had with VTM. In June 1999, Diamond  
16 contracted with VTM for assistance with the processing and payment of Diamond's freight charges.  
17 Under the written contract, VTM received, audited and validated transportation invoices on Diamond's  
18 behalf. The contract required VTM to submit weekly reports, called funding requests, to Diamond. The  
19 reports listed all invoices that were ready for payment. After reviewing the report, Diamond either  
20 approved or disapproved payment of the compiled invoices. According to Schedule A of the contract,  
21 VTM was then to effect "payment of Customer transportation billings presented by carriers and  
22 approved by [Diamond] and VTM, utilizing funds provided by [Diamond]." Diamond provided the  
23 necessary funds by transferring money into a segregated bank account in VTM's name. The contract  
24 provided that VTM "will issue payments to carriers upon deposit confirmation notice" from the bank  
25 where VTM maintained the segregated account. The parties expressly agreed that VTM would not  
26 advance its own funds to pay Diamond's carriers.

27 VTM charged a percentage fee for its service. It included its fee as part of the weekly funding  
28 requests and retained the portion of the funded amount that was attributable to its fee.

During the ninety day period preceding the filing of this bankruptcy case, VTM submitted twelve funding requests to Diamond, requesting the transfer of \$579,689.38 to the segregated bank account. Diamond funded \$578,020.31 of the requests, declining, on two occasions, to fund a total of \$1,669.07 owed to FedEx. Of the amount funded, \$576,820.31 was paid out to Diamond's freight carriers and VTM retained \$1,200.00 as its service fee. During the preference period, VTM generally paid the freight carriers' invoices within two to three days of receiving funds from Diamond. On one occasion there was one week gap between VTM's receipt of funds and its subsequent disbursement to Diamond's freight carriers. A ten day gap occurred on one other occasion.

### LEGAL DISCUSSION

Summary judgment obviates the need for trial where there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c). Here, the terms of the contract between Diamond and VTM are undisputed. The parties also do not dispute that VTM handled Diamond's freight bills as described above. The parties disagree, however, as to whether the resulting contractual relationship, as a matter of law, makes VTM an "initial transferee" of the funds it received from Diamond.

Under § 550(a)(1) of the Bankruptcy Code, a trustee or debtor-in-possession may recover avoided transfers from an "initial transferee" of the transfer. 11 U.S.C. § 550(a)(1). Neither the Bankruptcy Code nor its legislative history defines the term "transferee." In many situations, the initial transferee will be the first entity to whom the debtor transmits money or other assets. However, where a two step transaction is present in which the initial recipient is an intermediary between the debtor and the intended transferee of the asset, the ninth circuit has adopted the view that a mere recipient or conduit that does not have dominion over money or other asset is not a "transferee" within the meaning of § 550(a). *In re Cohen*, 300 F.3d 1097, 1102 (9<sup>th</sup> Cir. 2002); *In re Bullion Reserve of North America*, 922 F.2d 544, 548-49 (9<sup>th</sup> Cir. 1991). This so-called "dominion test" was first enunciated in *In re Bonded Financial Services, Inc.*, 838 F.2d 890, 893 (7<sup>th</sup> Cir. 1988), where Judge Easterbrook reasoned that as a matter of definition, a "transferee" within the meaning of § 550 must be something more than a mere recipient of transferred funds. Instead, the seventh circuit held, "the minimum requirement of

1 status as a ‘transferee’ is dominion over the money or other asset, the right to put the money to one’s  
2 own purposes.” *Id.* Since *Bonded*, the distinction between a mere recipient or conduit and a transferee  
3 within the meaning of § 550 has become the generally accepted view of the circuit courts. Dominion  
4 or control over an asset has been consistently required before a recipient constitutes an initial transferee.  
5 See e.g., *In re Hurtado*, 342 F.3d 528, 533 (6<sup>th</sup> Cir. 2003); *In re Finley, Kumble, Wagner, Heine,*  
6 *Underberg, Manley, Myerson & Casey*, 130 F.3d 52, 56-57 (2<sup>nd</sup> Cir. 1997); *Rupp v. Markgraf*, 95 F.3d  
7 936, 942 (10<sup>th</sup> Cir. 1996); *In re Reeves*, 65 F.3d 670, 676 (8<sup>th</sup> Cir. 1995); *In re Coutee*, 984 F.2d 138,  
8 140-41 (5<sup>th</sup> Cir. 1993); *In re Chase & Sanborn Corp.*, 848 F.2d 1196, 1199 (11<sup>th</sup> Cir. 1988).

9 Under the dominion test, the determinative factor is whether the entity that receives an asset has  
10 the right to put the asset to its own use. Dominion requires legal control over, not just mere possession  
11 of, the asset. *Cohen*, 300 F.3d at 1102. To be a transferee under § 550, a recipient must have the ability  
12 to use funds or other assets freely. *Id.* Thus, in *Bullion*, the ninth circuit found that a defendant’s  
13 contractual obligation to use the money it received to purchase stock and pledge the stock in favor of  
14 another prevented the defendant from having dominion or control of the money. *Bullion*, 922 F.2d at  
15 549. In *Cohen*, a debtor purchased a cashier’s check payable to one of her husband’s creditors and gave  
16 the check to her husband. The court determined that the husband’s limited right to retain, destroy or  
17 deliver the check to his creditor, the payee of the check, was not sufficient to satisfy the dominion test.  
18 300 F.3d at 1107.

19 In light of the ninth circuit’s approval of the dominion test, I am not persuaded by the debtors’  
20 assertion that, under *Bullion*’s formulation of the test, a recipient of funds only avoids being a transferee  
21 if the recipient demonstrates that it was an agent of the creditor that ultimately receives the funds. In  
22 other words, debtors assert as a matter of law that VTM is an initial transferee because there is no  
23 evidence that VTM was an agent of the various freight carriers that VTM ultimately paid. While the  
24 dominion test is used to distinguish between mere conduits and true transferees, nothing in the test  
25 requires a recipient to be the agent of anyone, much less of a transferee, before the recipient can avoid  
26 liability under § 550. Although the *Bullion* court restated a hypothetical example from *Bonded* “if A  
27 gives a check to B as agent for C, then B is not a transferee,” the court did not hold, or even suggest, that  
28 this hypothetical represents the only set of facts that would prevent transferee liability under § 550.

1 Significantly, the ninth circuit never determined whether the defendant in *Bullion* was anyone's agent.  
2 The court's analysis was limited to whether the defendant had the ability to use the funds freely.  
3 Because the defendant therein was contractually obligated to use the money in a particular way, it did  
4 not have dominion and was not a transferee of the funds.

5 Debtors' reliance on *In re Incomnet, Inc.*, 299 B.R. 574 (B.A.P. 9<sup>th</sup> Cir. 2003) to inject an  
6 agency requirement into the dominion test is similarly unconvincing. In that case, the Universal Service  
7 Administrative Company administered a federally regulated program under which telecommunication  
8 providers had to contribute a percentage of their revenues to USAC for the purpose of developing a  
9 universal telecommunication system. USAC argued that it was not a transferee of money it collected  
10 because Federal Communications Commission regulations restricted the USAC's use of the collected  
11 funds. In deciding that USAC was a transferee, the appellate panel reiterated the hypothetical example  
12 originally described in *Bonded*, but the court did not base its decision on the absence of an agency  
13 relationship. The crucial fact for the appellate panel was that *Incomnet* involved a one step transaction  
14 rather than a two step transaction where payment is made first to an intermediary followed by a second  
15 payment to the ultimate transferee. Because the USAC was not a conduit to any other entity, the court  
16 believed that the dominion test was inappropriate. Here, there is no question that a two step transaction  
17 is involved. The undisputed evidence establishes that Diamond transmitted funds to VTM with the  
18 expectation that VTM would then channel the money through to pay Diamond's freight carriers.

19 Other cases confirm that liability under § 550 can be avoided regardless of whether VTM was  
20 an agent of the freight carriers. In *Finley, Kumble*, an insurance broker acted on behalf of the *debtor*  
21 when it received debtor's funds and used them to purchase insurance for the debtor. The broker was  
22 not an initial transferee because the broker had no discretion to do anything other than transmit the  
23 money to the insurance provider. *Finley, Kumble*, 130 F.3d at 56-57. Similarly, a check courier hired  
24 by a debtor was not an initial transferee because it was contractually bound to deliver the check to the  
25 debtor's creditor. *Rupp v. Markgraf*, 95 F.3d at 940. Likewise, a port agent was not an initial transferee  
26 where it acted as a "disbursing agent" for the debtor shipping company by paying third party vendors  
27 with debtor's funds. *In re Timber Line, Inc.*, 59 B.R. 728 (Bankr. S.D.N.Y. 1986). From these  
28 examples, it is apparent that in a two step transaction, the tag assigned to the relationship between the

1 intermediary and the debtor or creditor is unimportant. The conduit may be an agent, a trustee, a courier  
2 or simply a party bound by the terms of a contract. It is the freedom or lack of freedom to control the  
3 funds that is determinative of an intermediary's status as a transferee.

4       Based on the authorities discussed above, I conclude that VTM is not an initial transferee of the  
5 funds that were ultimately paid to Diamond's freight carriers. Although debtors claim that there is  
6 nothing in the contract to require VTM to pay the freight carrier invoices, they are incorrect. A careful  
7 reading of the contract reveals that VTM was to effect payment of all invoices approved by Diamond.  
8 Further, payment was to issue "upon receipt of deposit confirmation" verifying that Diamond had  
9 transferred the funds needed to pay the invoices. This contractual obligation distinguishes this case  
10 from *Hurtado* on which the debtors heavily rely. In *Hurtado*, the debtors, a married couple, transferred  
11 legal title to their money to the husband's mother who maintained a separate bank account for the funds  
12 and used the funds at the debtors' direction. In finding the mother to be an initial transferee, the court  
13 specifically noted that there was no evidence of any formal contractual arrangement that required the  
14 mother to obey the debtors' commands or that provided recourse to the debtors if the mother chose not  
15 to follow their instructions. *Hurtado*, 342 F.3d at 535. Here, by contrast, there is a specific contractual  
16 provision that required VTM to pay Diamond's freight carriers. The debtors would have had recourse  
17 under the contract if VTM had failed to make the payments. VTM's legal obligation to disburse funds  
18 as set forth in the contract, blocked any dominion it might otherwise have had over the funds.  
19 Consistent with its legal obligations, VTM paid the carriers within a several days of receiving funds  
20 from Diamond. The undisputed facts establish that VTM was nothing more than a station stop along  
21 the route to the money's ultimate destination. Because VTM did not have the necessary dominion to  
22 be an initial transferee under § 550 of the Bankruptcy Code, VTM is entitled to summary judgment in  
23 its favor with respect to the funds ultimately paid to the freight carriers.

24       In light of the conclusion that VTM was not an initial transferee, it is unnecessary to address  
25 VTM's ordinary course of business defense with respect to the funds that went to the freight carriers.  
26 However, VTM did receive \$1,200 from Diamond as a fee for its freight auditing services. Based on  
27 the record before me, it is apparent that VTM had dominion over the funds attributable to its fee. It  
28 retained those funds and was able to use them without restriction. VTM asserts that it is entitled to

1 summary judgment even with respect to its fee because the fee was paid in accordance with the business  
2 terms and practices that the parties had followed for four years prior to the bankruptcy filing. Debtors  
3 reply that it has not had the opportunity to properly investigate the facts surrounding the ordinary course  
4 of business defense. Debtors' counsel has provided a declaration indicating that he believed the only  
5 issue to be addressed in the motions for summary judgment would be the dispute over VTM's status as  
6 an initial transferee. As a result, counsel states, he deferred discovery related to the ordinary course of  
7 business defense until after the court ruled on the motions for summary judgment. Pursuant to Fed. R.  
8 Civ. P. 56(f), the debtors request that any counter motion based on the ordinary course of business  
9 defense be denied pending further discovery on that issue. In light of the debtors' Rule 56(f) request,  
10 it is appropriate to deny VTM's counter motion for summary judgment, without prejudice, as to the fees  
11 it received from debtors during the ninety day period preceding this bankruptcy case.

12 For the reasons explained, plaintiffs' motion for partial summary judgment is denied. The  
13 defendant's cross-motion for summary judgment is granted with respect to the \$576,820.31 that VTM  
14 ultimately paid out to the debtors' freight carriers and is denied, without prejudice, as to the \$1,200.00  
15 that VTM received as a fee for its services.

16 Good cause appearing, IT IS SO ORDERED.

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18 \*\*\*\*\* END OF ORDER \*\*\*\*\*  
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Adv. P. 05-5106

**UNITED STATES BANKRUPTCY COURT**  
**FOR THE NORTHERN DISTRICT OF CALIFORNIA**  
**SERVICE LIST**

Matthew S. Walker  
William B. Freeman  
Pillsbury Winthrop Shaw Pittman, LLP  
101 West Broadway, Suite 1800  
San Diego, CA 92101-8219

Linda M. Gonsalves  
Stephen F. Heller  
Gonsalves & Kozachenko  
1133 Auburn Street  
Fremont, CA 94538